CLEARING HOUSES—LIABILITY OF MEMBER BANKS FOR BANKS FOR WHICH THEY CLEAR.

THIS article is a continuation of one contained in the VIRGINIA LAW REVIEW for March, 1915, entitled "The Law of Clearing Houses," in which the general principles of the law of this important piece of our financial machinery were outlined. In that article it was said: "A review of the subject would not be complete without at least a reference to the liability of a member bank for checks upon banks which are not members but for which it clears." It is proposed in this article to complete the treatment of the subject.

Briefly stated, the proposition is this: Has a bank, a member of a clearing house, the legal right to guaranty the payment of a check drawn on another bank, not a member, but for which the first bank clears?

The machinery of a clearing house, apparently complicated but really simple, was described in some detail in the previous article, to which description nothing need be added here further than to present an illustration in the way of putting the foregoing proposition through the machine.

Thus: The A, B, C, D and E banks are members of the clearing house. The X bank of the same city, however, being desirous of obtaining clearing house advantages without the burdens of membership, makes application to, say, the B bank to be allowed to clear through it, subject to the rules of the clearing house. The rules in this particular permit such a relation and provide in substance that the liability of members for banks which are not members shall be *the same as for their own transactions* and shall continue until due notice of discontinuance of such agency shall have been given. Now, on a certain morning, checks upon the X bank are at the meeting of the clearing house put into the envelope of the B bank by each of the other members and are charged to the B bank. It delivers them in turn to

the X bank, which retains them until a time later than that permitted by the rules for the return of dishonored checks, *and then announces its insolvency*. *Quære,* assuming that the checks were good on the books of the X bank, is the B bank liable upon its guaranty that the X bank will pay the checks?

This may seem at first glance a simple question, the tendency being to answer it in the affirmative. But if that is the correct answer, there has been a strange reluctance to give it on the part of judicial and administrative officers. In 1912 the question was propounded as to national banks to the Comptroller of the Currency, who replied as follows:

> "You are advised that this office has made no ruling upon the subject, and the question of the liability of national banks under the section of the clearing house rule does not appear to be one for the determination of this office in advance. Should a national bank become insolvent, the question might arise for an official decision."

Whether or not there is any significance in the last sentence of the letter is a subject of conjecture, but it is believed that a confident expression of opinion as to what view of the queetion the courts would take can not safely be made.

So far as the writer's investigations of the authorities in point go, the question of the guaranty by one bank for clearing house purposes of checks drawn upon another has never been squarely decided by any of the courts, state or federal, of this country. The court which came nearest to it was the Supreme Court of Illinois, before which the point of *ultra vires* was specifically raised in argument in the case of Voltz *v.* National Bank of Illinois.[1] The court declined to pass upon the question, holding in the circumstances of the case that *even if* the guaranty of checks by one national bank to another for clearing house purposes is *ultra vires,* this fact will not avail the *drawees* of a check who are not parties to the guaranty, when charged with liability to the bank, which, in compliance with its said guaranty, had paid the check and become an assignee thereof after the drawer becomes insolvent. Said the court:[2]

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[1] 158 Ill. 532, 42 N. E. 69.
[2] 158 Ill. 532, 42 N. E. 69, 72.

"But the determination of the question whether the guaranty contract is *ultra vires* and void, or void as being otherwise contrary to the statute under which appellee was organized, or against public policy, depends upon the interpretation that is to be placed upon the National Bank Act and the effect to be given its provisions. It may be that if a statute of this State was involved, then the rule that no right of action can spring out of an illegal contract (held in Penn *v.* Boorman, 102 Ill. 523, and in other cases), would apply. But in the very case just cited the paramount authority of the Supreme Court of the United States to construe all Federal statutes, including the National Bank Act, is fully conceded. The doctrine of the Federal courts, as applied to this case, is: that even if the guaranty which appellee gave to the First National Bank was *ultra vires,* or given in violation of the National Bank Act, yet appellee could not urge that defense after the First National Bank, in reliance upon that guaranty, had taken the certified check in payment of the acceptance of F. L. Voltz & Co., and that the power to redress the wrong committed by the appellee bank was in the government only, by a proceeding to forfeit the charter of the bank. National Bank *v.* Matthews, 98 U. S. 621; National Bank *v.* Whitney, 103 U. S. 99; Weber *v.* Spokane Nat. Bank (C. C. A.), 64 Fed. 208."

The scope of the question for many practical purposes must be considerably reduced when circumstances exist upon which an estoppel may be predicated. In their absence or insufficiency in number or character to create an estoppel, the question still presents itself. Perhaps it will never be, as it appears never to have been, answered. Let us examine briefly, however, certain of the authorities upon what is and what is not *ultra vires* a bank—first, a national, and, second, a state bank.

In the recent case of First National Bank *v.* Monroe,[3] the Supreme Court of Georgia said:

"Corporations are creatures of law and their powers are limited. Every person is presumed to know the law, and is charged with notice of the limitations on the powers of a corporation fixed thereby. Rev. St. U. S., § 5136 (U. S. Comp. St. 1901, p. 3455), gives to a national bank the power to 'make contracts' and 'to exercise by its board of

[3] 135 Ga. 614, 615, 69 S. E. 1123, 1124.

directors, or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing and circulating notes according to the provisions of this title.' The provisions referred to do not give power to a national bank to guarantee the payment of the obligations of others solely for their benefit, nor is such power incidental to the transaction of the business of banking. A bank can lend its money, but not its credit. See McGee on Banks & Banking, § 248; 1 Morse on Banks and Banking, §§ 65, 169; 1 Bolles on Law of Banking, § 25; Bolles on the National Bank Act Annotated (4th ed.), 40, § 10. A national bank in negotiating its paper can bind itself for the payment thereof by its indorsement thereon, but it cannot guarantee the payment of the paper of others, or become surety thereon, solely for the benefit of the latter."

This is the general law of the subject, but its application to particular cases has been the source of a considerable variety of judicial opinion.

There is, of course, no doubt of the power of a bank to guaranty negotiable paper in the course of its business. In the leading case of Peoples National Bank *v.* National Bank,[4] the Supreme Court of the United States held that where a president of a bank negotiated for value a certain note and at the same time executed in the name of the bank a separate written guaranty of payment, it was binding upon the bank and within its powers, the court saying that any other conclusion would be a reproach to our jurisprudence.

It is when we leave the territory covered by the expression, "the usual course of business," that the difficulties of the question begin. And it must be confessed that at times it is not easy to perceive the exact line of demarcation between those contracts of guaranty pronounced within and those pronounced without the powers of a bank.

As has been stated, one of the touchstones of the question

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[4] 101 U. S. 181.

is as to whether or not a bank, in making the guaranty in question, *lends its credit*. If it does, it is *ultra vires*. One of the best-known authorities upon the subject says: [5]

> "Neither as included in its powers nor incidental to them is it part of a bank's business to lend its credit. If a bank would lend its credit as well as its money, it might, if it received a compensation and was careful to put its name only to solid paper, make a great deal more than any lawful interest on its money would amount to. If not careful, the power would be the mother of panics, and if no compensation was received, there is the additional reason, if any is needed, that such a power is in derogation of the rights and interests of stockholders, and at all events could only be exercised with the consent of all. Indeed, lending credit is the exact opposite of lending money, which is the real business of a bank, for while the latter creates a liability in favor of the bank, the former gives rise to a liability of the bank to another."

Certain of the cases in which the question of what is meant by a "lending of credit" was considered are the following:

In the frequently cited case of Seligman *v.* Charlottesville National Bank,[6] it was held by Judge Bond, of the Fourth Circuit, that a national bank, *upon deposit of collateral security with it*, has no power to guaranty the obligations of the person making the deposit.

This was what is popularly known as an extremely "hard case," but the court did not for that reason permit it to make bad law. There was no dispute about the fact that the bank had agreed to make the guaranty and, of course, it may be presumed, "not solely for the benefit" of the party guarantied—but the court held that the guaranty was invalid and the creditor who relied upon it lost his debt.

In Johnston *v.* Charlottesville National Bank,[7] it was held that a national bank cannot make or indorse drafts or notes for the accommodation of another.

In Bowen *v.* Needles National Bank,[8] it was held that a na-

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[5] Morse, Banks and Banking, § 65.

[6] 3 Hughes 647.

[7] 3 Hughes 657.

[8] (C. C. A.), 94 Fed. 925.

tional bank has no power to lend its credit to any person or corporation or to become guarantor of the obligations of another, except in the transfer of promissory notes discounted, which is in the ordinary course of banking.

In Fidelity & Deposit Co. *v.* National Bank of Commerce,[9] it was held that a bank has no power to certify an instrument by which the drawers agreed to pay their surety any amount the surety might be required to pay by virtue of such suretyship, not exceeding $10,000, the check to be void in the absence of such liability, such an instrument not being a commercial check, drawn in the ordinary course of the banking business.

In Merchants National Bank *v.* Baird,[10] it was held that a national bank may warrant the title to the property which it conveys or it may become liable as an indorser or guarantor of obligations *which it rediscounts or sells*, but it cannot lend its credit to another by becoming surety, accommodation indorser or guarantor for him. Such an act is *ultra vires*, and, when its true character is known, no rights grow out of it.

In the recent case of Barron *v.* McKinnon,[11] it was held that where a national bank in order to induce complainant to purchase certain steamship stocks owned by it, agreed to take complainant's note for $5,000 for the stock and hold the stock as collateral security and to guaranty complainant against any loss in the transaction from the execution and delivery of the note, such guaranty was not an *ordinary commercial guaranty* but one outside of the ordinary business of banking and *ultra vires*.

An illustration of a transaction which is within the powers of a national bank is presented in the case of Schofield *v.* State National Bank,[12] in which an agreement to assume all the liabilities of another national bank in consideration of the transfer of its banking office and *sufficient of its assets to cover the assumed liability* was held to be not *ultra vires*. The difference between this case and the others seems manifest—a difference of principle.

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[9] 48 Tex. Civ. App. 301, 106 S. W. 782.

[10] (C. C. A.), 160 Fed. 642.

[11] (C. C.), 179 Fed. 759.

[12] (C. C. A.), 97 Fed. 282.

From the foregoing statement of the general law and the instances of its application, one of three elements appears to have controlled the decision in each case. First, whether or not the transaction was solely for the benefit of the guarantied party; second, whether or not it was in the ordinary course of banking business, and third, whether or not it was a lending of credit.

Upon the first, it may be said that if the non-member bank keeps an account with the clearing bank and does other incidental business with it, this might be pronounced to make the transaction not solely for the benefit of the former. Other guaranties, however, from which the guarantying banks seem to have derived a much more direct and substantial benefit, have been held invalid.

We have found no direct authority as to whether or not the guaranty under consideration is "in the ordinary course of the banking business." But we should not lose sight of the fact that the articles of association of clearing houses throughout the country have contained guaranty provisions and that in the half century in which they have been in operation—in the course of which non-member banks have only too often become insolvent—the number of cases in which the validity of the guaranty has been even questioned has been notably small. The value of this somewhat negative reason is, however, considerably lessened by the refusal of the Comptroller of the Currency, *supra,* to rule upon the question *until a case of insolvency arises.*

The question being then an open one, we do not prudently, after the manner of the modern law text-book, content ourselves with a statement of the fact, but we express an opinion, and that is that, aside from considerations of estoppel, the guaranty in question is a lending of credit within the inhibition of the National Banking Act. It is susceptible of becoming and being construed as an unlimited letter of credit. It is good for any amount or it is not good for any purpose. There is no middle ground. If in its usual terms it is good for $1,000, it is good for $50,000. While it is probable that checks upon the non-member bank will average daily only so much, for which the collateral of a percentage of the total deposits of the non-mem-

ber bank required by the member bank will be sufficient security, it is by no means impossible that checks may come in to an amount greatly in excess of that collateral, and thus the guaranty contract becomes one of an unlimited liability. This would seem to come within the forbidden "lending of credit," the only legitimate extent of which is for actual or supposedly actual value received.

The question, as it affects state banks in Virginia, is different. Their powers are more ample than those of national banks. Section 1161 of the Code of Virginia is as follows:

> "Every such bank or banking institution shall have power to exercise by its board of directors, or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating bills of exchange, promissory notes, drafts, and other evidences of debt; by receiving deposits; by buying and selling exchanges, coin, and bullion, and by loaning money on real and personal security or collateral; *by guaranteeing the payment of bonds, bills, notes and other obligations;* by rediscounting paper; and in purchasing and selling all stocks and bonds."

If by this the legislature intended to confer powers of guaranty limited only by the discretion of the board of directors, there can be no doubt of the validity of the guaranty by a state bank of the nature now under consideration. The affirmative utterance of the Supreme Court of Appeals of the state, however, would be necessary to convince the writer that this clause in the statute means that the banks of Virginia are free to embark at any time upon a guaranty or underwriting business. It is again significant that they have never, as a class, acted upon this view of their rights, only six of the 176 banks of the state having gone so far even as to guaranty and sell bonds of other parties secured by first mortgage on real estate. The reason is not far to seek, being that the moment a bank of deposit embarks upon the business of lending its credit, it turns aside from its "real business," as Mr. Morse calls it, of lending money and embarks upon that which is "its exact opposite," and tending as he wisely says, "if not careful," to convert the power into the "mother of panics."

Rather does the case seem to the writer one for the application to the statute of the rules, *noscitur a sociis* and *ejusdem generis,* under which these broad terms would be wisely narrowed. State banks, says the statute, shall have "all such incidental powers as shall be necessary to carry on the *business of banking.*" That is the genus—the controlling expression—from which the meaning of the words which follow should be gathered. We have seen, however, that the business of banking is *not* the business of lending credit, and we would construe the express power "to carry on the business of banking * * * by guaranteeing the payment of bonds, bills, notes and other obligations" to mean a guarantee of those instruments when incidental to the deposit and discount business—"the real business"—of the bank, e. g., the warranties as to genuineness, title and the capacity of prior parties to contract, contemplated in sections 65 and 66 of the Negotiable Instruments Law, and kindred guaranties, *and none other.*

The question has never been submitted to the Virginia court of last resort, but that court has repeatedly applied the rules of construction mentioned.[13] It is believed that the legislature, however ample may have been its language, did not intend to authorize the banks of its creation to embark upon the tempting but more or less dangerous sea of guaranty troubles without at least an amendment of their charters under the Act of March 27, 1914, thus in effect becoming trust or guaranty companies and incorporating accordingly the word "trust" in their names, so that the public may understand the nature of their business and that they are lending their credit as well as their depositors' money. This done, no legal objection could be made to the entering of a state bank upon a general guaranty business, of which the clearing house guaranty would be only a single feature, whose validity none could doubt.

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[13] Gates *v.* Richmond, 103 Va. 702, 49 S. E. 965, and cases cited.